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SUBJECT: EADS' TANKER WIN - ANATOMY OF A (VERY BIG) DEFENSE
CONTRACT

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REF: 06 MUNICH 558

SUMMARY

¶1. (SBU) THE FEBRUARY 29 ANNOUNCEMENT THAT THE U.S. AIR FORCE WOULD
AWARD A USD 40 BILLION CONTRACT FOR AERIAL REFUELING TANKERS TO A
CONSORTIUM FORMED BY EADS AND NORTHROP GRUMMAN, A DEAL THAT DEFENSE
EXPERTS HAD BEEN ALL- BUT-CERTAIN WOULD GO TO BOEING, LANDED LIKE A
BOMBSHELL AT EADS' CO-HEADQUARTERS OUTSIDE OF MUNICH. EADS HAD
HOPED TO GET, AT BEST, A PORTION OF A SPLIT DEAL WITH BOEING. THE
DEAL MARKS THE CULMINATION OF EADS' EFFORT TO BECOME A PLAYER IN THE
U.S. DEFENSE MARKET BY BUILDING ALLIANCES WITH U.S. DEFENSE
CONTRACTORS AND LOCATING PRODUCTION FACILITIES IN THE U.S.

LARGEST PENTAGON CONTRACT EVER TO GO TO A FOREIGN FIRM

¶2. (U) ON FEBRUARY 29, THE U.S. AIR FORCE ANNOUNCED ITS SELECTION
OF A NORTHROP GRUMMAN-EADS (EUROPEAN AERONAUTIC, DEFENSE AND SPACE)
PARTNERSHIP OVER BOEING TO BUILD 179 NEW "KC-45" AERIAL REFUELING
TANKERS TO REPLACE THE MILITARY'S AGING FLEET OF BOEING 707-BASED
KC-135S. THE IMPORTANCE OF THE USD 40 BILLION CONTRACT -- THE
LARGEST EVER U.S. DEFENSE CONTRACT TO GO TO A FOREIGN CONTRACTOR --
TO EADS, IS DIFFICULT TO OVERSTATE. THE NORTHROP/EADS KC-45 IS
BASED ON A MODIFIED VERSION OF THE EADS/AIRBUS A330 WIDEBODY
AIRFRAME AND WILL BE ASSEMBLED AT A FACTORY IN MOBILE, ALABAMA,
USING A330 SUBASSEMBLIES SHIPPED FROM EUROPE. AT LEAST 58 PERCENT
OF THE AIRCRAFT'S CONTENT, INCLUDING GE ENGINES, WILL BE SOURCED IN
THE U.S. THIS INITIAL AWARD WILL COVER THE FIRST PART OF A
MULTI-PHASED CONTRACT SPANNING SEVERAL DECADES, WITH THE FIRST KC-45
EXPECTED TO GO INTO SERVICE IN 2013. OVER TIME, THE AIR FORCE PLANS
TO REPLACE MORE THAN 500 KC-135S AT A TOTAL PRICE ESTIMATED AT MORE
THAN USD 100 BILLION. ACCORDING TO AIR FORCE OFFICIALS IT'S
POSSIBLE THAT LATER PHASES OF THE CONTRACT COULD BE AWARDED TO
BOEING, WHICH OFFERED A MODIFIED VERSION OF ITS WIDEBODY 767 IN ITS
BID.

"WE'RE THRILLED, BUT HOLDING OUR BREATH..."

13. (SBU) A SENIOR EADS OFFICIAL TOLD CONGEN MUNICH THAT THE AIR FORCE ANNOUNCEMENT CAME AS A VERY PLEASANT SURPRISE; EADS HAD HOPED, AT BEST, TO BE AWARDED ONLY A PORTION OF A SPLIT CONTRACT WITH BOEING. HE ADDED THAT THE AWARD HAD NOT ONLY OPENED THE DOOR FOR A SIGNIFICANT PHYSICAL PRESENCE IN THE U.S. FOR EADS, BUT WOULD ALSO ESTABLISH A MINI-AEROSPACE INDUSTRY AROUND THE TANKER'S PRODUCTION IN ALABAMA, GIVEN THE MANY SUB-CONTRACTORS AND OTHER FIRMS NEEDED TO SUPPORT LARGE-SCALE AIRCRAFT PRODUCTION. THE EADS OFFICIAL SAID HE WAS CONFIDENT THAT EADS' PERFORMANCE WITH OTHER U.S. DEFENSE CONTRACTS, MOST NOTABLY WITH THE U.S. ARMY'S EUROCOPTER UH-72 "LAKOTA" LIGHT HELICOPTER (REFTTEL), HAD EASED ANY CONCERNS THE AIR FORCE MAY HAVE HAD WITH SELECTING A FOREIGN FIRM.

14. (SBU) THE SAME EADS CONTACT DID EXPRESS CONCERN, HOWEVER, THAT THE AWARD WAS "NOT A DONE DEAL," GIVEN THE STRONG POSSIBILITY THAT BOEING WOULD CONTEST THE DECISION, WITH THE SUPPORT OF CONGRESSIONAL DELEGATIONS FROM ILLINOIS (BOEING'S HEADQUARTERS), WASHINGTON STATE (WHERE 767S ARE PRODUCED), AND KANSAS (WHERE THE 767S WOULD BE CONVERTED INTO TANKERS). THE EADS OFFICIAL ADDED, HOWEVER, THAT THE GOVERNOR OF ALABAMA, ALONG WITH THE STATE'S CONGRESSIONAL DELEGATION, HAD HAILED THE NEWS OF THE CONTRACT AWARD. HE ALSO SAID THE CONTRACT REPRESENTED A VINDICATION FOR AIRBUS CEO TOM ENDERS, WHOM HE CALLED "A BIG SUPPORTER OF THE TRANSATLANTIC STORY."

"MADE IN AMERICA"

15. (SBU) EADS VIEWED ITS 2006 SUCCESS IN WINNING THE USD THREE BILLION CONTRACT TO SUPPLY THE U.S. ARMY WITH OVER 300 UH-72 LIGHT HELICOPTERS -- EADS FIRST MAJOR ENTRY INTO THE U.S. DEFENSE MARKET -- AS A STEPPING STONE TO THE MASSIVE AIR FORCE TANKER CONTRACT. LAST YEAR A SENIOR EUROCOPTER OFFICIAL TOLD THE CONSULATE THAT IN ADDITION TO IMPROVING THE STANDING OF EUROCOPTER WITHIN THE EADS CONSORTIUM, EUROCOPTER'S SUCCESS AT BREAKING INTO THE U.S. DEFENSE MARKET WOULD INCREASE THE PRESSURE ON HIS COLLEAGUES AT EADS TO WIN

ALL OR PART OF THE AIR FORCE CONTRACT.

16. (SBU) EADS LEARNED SEVERAL KEY LESSONS FROM THE EUROCOPTER SUCCESS, WHICH IT APPLIED TO THE TANKER BID. FIRST, THE IMPORTANCE OF PUTTING A U.S. "FACE" ON THE BID. IN THE CASE OF EUROCOPTER, THE FACE WAS U.S. HELICOPTER MANUFACTURER SIKORSKY, WHICH WAS TAPPED BY EADS TO PROVIDE CONTRACTOR LOGISTICS SUPPORT (CLS) AS PART OF THE BID. EADS OFFICIALS TOLD US THAT SIKORSKY'S NAME AND FAMILIARITY WITH U.S. DEFENSE CONTRACTING WAS KEY IN SELLING THE BID TO THE ARMY. IN THE CASE OF THE KC-45 TANKER, NORTHROP GRUMMAN WAS THE PARTNER. WHILE THE EADS KC-45 WILL BE SUBSTANTIALLY THE SAME AIRFRAME AS AN AIRBUS A330, NORTHROP WILL MANAGE THE PROGRAM'S LARGE NUMBER OF SUPPLIERS AND WILL INSTALL DEFENSIVE AND OTHER SYSTEMS ON THE AIRCRAFT. BUT MOST IMPORTANTLY, THE PARTNERSHIP WITH NORTHROP ALLOWED EADS TO MARKET ITS TANKER IN THE U.S. UNDER THE NAME OF A RESPECTED PILLAR OF THE U.S. DEFENSE ESTABLISHMENT.

17. (SBU) SECOND, EADS LEARNED THAT IT NEEDED TO GIVE THE "MADE IN AMERICA" LABEL -- WITH ALL THE ECONOMIC BENEFITS THAT IT IMPLIES -- TO ITS TANKER PROPOSAL. IN THE CASE OF EUROCOPTER, THE DECISION WAS MADE TO LOCATE FINAL ASSEMBLY OF THE UH-72 IN COLUMBUS, MISSISSIPPI. FOR THE KC-45 TANKER, MOBILE, ALABAMA WAS CHOSEN FROM SEVERAL POTENTIAL SITES IN THE SOUTHERN U.S. THE WEB-SITE FOR THE KC-45 PROGRAM PROUDLY CLAIMS THAT THE TANKER PROGRAM "WILL EMPLOY 25,000 AMERICAN WORKERS AT 230 U.S. COMPANIES IN 49 STATES." IN JANUARY 2008, EADS FURTHER SWEETENED THE DEAL BY ANNOUNCING THAT IF IT WERE AWARDED THE TANKER CONTRACT, IT WOULD ASSEMBLE ALL OF ITS A330 COMMERCIAL FREIGHTER AIRCRAFT AT THE MOBILE SITE AS WELL, CREATING AN ECONOMIC "MULTIPLIER EFFECT" FROM THE TANKER PROGRAM. A SENIOR EADS OFFICIAL TOLD THE CONSULATE THAT EADS/AIRBUS MIGHT ELECT TO ALSO BUILD OTHER COMMERCIAL AIRCRAFT BEYOND THE A330 FREIGHTER AT THE MOBILE PLANT IN THE FUTURE.

MITIGATING THE WEAK DOLLAR

18. (U) BECAUSE ALL LARGE COMMERCIAL AIRCRAFT ARE PRICED IN U.S. DOLLARS REGARDLESS OF WHERE THEY ARE MANUFACTURED, EADS/AIRBUS COMPLAINED OF A TREMENDOUS FINANCIAL STRAIN DUE TO THE RELATIVE

STRENGTH OF THE EURO TO THE DOLLAR. IN NOVEMBER 2007, AIRBUS CEO TOM ENDERS TOLD THE MEDIA THAT "THE DOLLAR'S RAPID DECLINE IS LIFE-THREATENING FOR AIRBUS," AND THAT "THE DOLLAR EXCHANGE RATE HAS GONE BEYOND THE PAIN BARRIER." ENDERS ADDED THAT PART OF THE STRATEGY TO COMBAT THE IMPACT OF THE WEAK DOLLAR WOULD BE TO POSSIBLY SHIFT SOME PRODUCTION TO DOLLAR-ZONE COUNTRIES. BY ASSEMBLING THE KC-45 TANKER AND A330 FREIGHTER IN ALABAMA, EADS HAS FOUND A WAY TO LOWER ITS PRODUCTION COSTS WHILE SIMULTANEOUSLY SELLING THE ECONOMIC BENEFITS TO THE U.S. ECONOMY.

COMMENT

¶9. (SBU) THE KC-45 TANKER AWARD IS THE LARGEST U.S. DEFENSE CONTRACT TO EVER BE AWARDED TO A FOREIGN CONTRACTOR, AND REPRESENTS ONE OF THE LARGEST ORDERS IN AEROSPACE HISTORY. FOR EADS, IT ALSO REPRESENTS RECOGNITION THAT THE FIRM IS A PLAYER IN THE U.S. DEFENSE MARKET, AND CAN HOLD ITS OWN AGAINST FORMIDABLE COMPETITION SUCH AS BOEING -- A FACT THAT WON'T HURT EADS' SALES WORLDWIDE. EADS IS ALL TOO AWARE THAT EUROPEAN GOVERNMENTS, FACING INCREASING DEMOGRAPHIC-INDUCED SOCIAL COSTS AND A LACK OF PUBLIC SUPPORT FOR INCREASED MILITARY SPENDING, WILL NOT PROVIDE SIGNIFICANT OPPORTUNITIES FOR THE FIRM'S FUTURE GROWTH. WITH THE U.S. SPENDING MORE ON DEFENSE THAN THE REST OF THE WORLD COMBINED, EADS MADE A STRATEGIC DECISION TO GO "WHERE THE MONEY IS" -- A BET THAT APPEARS TO BE PAYING OFF BEYOND EADS EXECUTIVES' MOST OPTIMISTIC EXPECTATIONS.

¶10. (U) THIS REPORT HAS BEEN COORDINATED WITH EMBASSY BERLIN.

¶11. (U) PREVIOUS REPORTING FROM MUNICH IS AVAILABLE ON OUR SIPRNET WEBSITE AT WWW.STATE.SGOV.GOV/P/EUR/MUNICH/ .

NELSON